Monthly Analysis – July

Gábor Orbán: Growing demand and supply in the government bond market

On 2 July the State Debt Management Centre (ÁKK) sold HUF 41.5 billion in 3, 5 and 10-year government bonds at single-digit yields. Encouraged by the success of this auction the ÁKK decided to raise the quantity on offer, and two weeks later sold another HUF 85 billion's worth at even lower yields. Following this, investors also bought a billion euros' worth of five-year FX bonds from the Hungarian state. The oversubscription of the forint securities by a factor of 2.5-3, coupled with the marked reduction in yields, points to considerable demand potential. In terms of the quantities sold, if lots of this size were "snapped up" every two weeks, we wouldn't be so far off the issued volumes of the last pre-crisis year of 2007. If the sales continue with the most recently announced items (also taking into account the 40% non-competitive issue opportunity), an annual gross bond issue of over HUF 2,000 billion is within reach, and there is a realistic chance that the state will be capable of financing itself without the need to draw down any more IMF funds. (This, of course, does not necessarily mean another, smaller standby loan won't be necessary at a later date, in order to perpetuate the credit already utilised).

With regard to the structure of the bond issues, events have taken a positive turn (the State Debt Management Centre is correctly making an effort to sell higher volumes at the shorter maturities); however there is still room for improvement, as investors in the MAX reference index need to buy three times as many three-year papers than ten-year ones (and twice as many five-year bonds than ten-year ones) in order to maintain their risk in line with that of the index. Besides this, it is also in the best interests of the state to avoid, as far as it can, continuing to rack up debt at the still-high forward interest rates of over 8%. Another important lesson of the recent period is that the country's improving credit risk rating is both a cause and a consequence of the decline in distant forwards, and the flattening of the yield curve. Regardless of which came first in this chicken-and-egg scenario, it is now advisable to concentrate bond issues on the shorter maturities, which is precisely what all debt managers are doing, both locally and in the broader region.

Since the weight of Hungarian government bonds within managed assets has fallen substantially over the past six months, both at Hungarian and foreign fund managers, there has been (and still is) a great deal of pent-up demand in the system. At first this demand was generally stronger at the 1-3-year maturities, which had been dried out by the repurchase auctions. However, as hopes of a return to market financing rose, the overall perception of the country's long-term solvency also improved, and after a while the longer maturities grew in popularity. The other key factor in the growing demand for forint bonds is that a cut in interest rates has come to be widely expected, especially now that Hungary is virtually the only remaining emerging market in which there is still significant scope for such a reduction. The National Bank of Hungary previously sent out the message that a sustained improvement in risk perception will be required in order for it to bring down the base rate. The fact that such an improvement has taken place is clear from asset prices (market values, yields, FX swap bases, asset swap premiums, CDs), and from the high volumes (issues, etc.) traded at these prices. The easing of financing tensions is also underpinned by fundamentals, as the banking system's balance-sheet FX swap position has closed to a certain extent, leaving it less dependent on the previously overburdened FX swap market, while budgetary policy has also been given a thorough reworking, which has led to an improvement in investors' perception of future financing requirements. Following the restoration of FX liquidity and the successful government bond auctions, it is now a defensible viewpoint that the lower country-specific risk premium will be sustained, so it is no wonder that 20 out of 20 analysts believe there is scope for a cut in the base rate.

The recently announced change to private pension fund regulations could lead to a further strengthening of demand. Insofar as it can be ascertained from the current composition of the pension funds' reference indexes, due to the limits imposed on private pension funds' exposure to foreign-currency securities, the demand among private pension funds for forint securities (presumably government bonds, first and foremost) could rise by some HUF 110 billion, almost double the current level, over the coming year. In order to comply with the newly imposed limits by the specified deadline of this December (5% for a 'classic', 20% for a 'balanced', and 45% for a 'growth' portfolio), it will be necessary to reallocate approximately HUF 45 billion's worth of securities, a third of which will have to be achieved through active selling, and the remainder by investing 100% of incoming payments in forint instruments. By next September, due to a further reduction in the limit applicable to 'growth' portfolios, to 35%, incoming payments will once again have to be exclusively invested in forint instruments by funds that exceed this limit. This will result in a further HUF 50-55 billion in additional demand. In addition to this process of 'passive adaptation', it will also be necessary to directly restructure portfolios (through the sale of FX assets) in a value of HUF 10-15 billion. Another long-term impact is that from now on the health and pension fund sector will invest a higher proportion of its incoming payments in forint-denominated assets, which from 2011 will represent an extra HUF 20-30 billion in demand every year.

As a result of all this there is no serious demand pressure worth speaking of, in contrast, for example, with the fall in demand (and rise in supply) on the government bond market following the launch of the optional portfolio system, which was four or five times the extent of this one. Additionally, the new regulations could contribute substantively to an improvement in investor sentiment, and over the long term to lower and less volatile yields. It can also be assumed that the change will lead to the disappearance, or at least a narrowing of, the discount at which Hungarian equities are traded in comparison to their counterparts in Poland, where the limit on FX securities in pension funds is far stricter than in Hungary (5%, to be gradually raised to 30% by 2015). With regard to the new legislation's impact on the forint market, given that, according to anecdotal evidence, a considerable proportion of FX exposure has nonetheless been hedged by the funds, the impact over a year will be half of the extra demand for forint instruments at most, or some EUR 200 million, which is not significant.

How low can the yields go? A sustained period of strong supply will obviously prop up the yields in future; however, it is conceivable (assuming volatility remains low in the global financial markets, by which I mean a VIX of around or below 30 points) that the yields on Hungarian government securities, similarly to the prices of other risky instruments, will return to the levels of before the Lehman collapse of last September. As regards the premium over German government bonds, this represents more than 200 basis points of scope for a drop in the Hungarian 10-year yield, but even in terms of the absolute 10-year yield some 100 basis points remain in reserve. At the five-year maturity the situation is more complicated, since

bond yield curves in the developed markets, including Germany, have become exceptionally steep in the past year due to the simultaneous relaxing of monetary and budgetary policy. Thus, the five-year segment is at a neutral valuation level in absolute terms, though, in comparison to the German papers, it is still 300 basis points higher than at this time last year. Since, for the time being, the NBH cannot consider cutting interest as aggressively as most of the foreign central banks, the five-year segment is likely to underperform the ten-year maturity over the coming months.

Taking all factors into consideration, parallel rises in demand and supply in the forint government bonds market can be expected in the months ahead, which in itself would not be a positive development. However, in view of the fact that the greatest challenge faced by the country is to wean itself off the IMF credit facility, it is on the whole favourable from the perspective of Hungarian asset prices, including the government bond and corporate bond premiums, which remain at favourable valuation levels, and the prices of equities.

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